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No. 79-1266

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

CHARLES W. STEADMAN,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

INTRODUCTION

Respondent's discussion of the issues presented by this case relies on two mistaken premises. First, respondent maintains that the Court lacks authority to establish or to recognize the clear and convincing standard of proof in SEC disciplinary proceedings. For reasons discussed in Part I, below, that contention cannot be sustained; neither the legislative history of the Administrative Procedure Act nor any doctrine of "agency discretion" provides support for respondent's argument.

Second, respondent's asserted "balancing" of the interests affected by the standard of proof is infirm. As demonstrated in Part II, below, respondent fails to recognize institutional factors and procedural advantages that tilt the probable outcome in SEC disciplinary proceedings heavily in favor of the government. Moreover, respondent fails to consider various aspects of the *public* interest that warrant a heightened standard of proof.

Before addressing those issues, however, one preliminary comment is in order. Departing even from its own brief supporting the petition for certiorari, respondent has attempted to alter fundamentally the issue presented to this Court for review. That issue, which has been endorsed by respondent and accepted by this Court, addresses the standard of proof required in SEC disciplinary proceedings to support findings of "violations of antifraud provisions of the federal securities laws . . ." SEC Br. Cert. 1-2. Yet, in its brief on the merits, respondent has limited the scope of the question to findings of "violations *by a fiduciary* of antifraud provisions . . ." SEC Br. i (emphasis added). That subtle but significant change is then used by respondent in an attempt to distort the underlying balance that is dispositive of the merits of this dispute.

Respondent's attempt to distort the issues in this manner cannot be sustained. The SEC has no authority whatsoever to consider breaches of fiduciary duty, if any, in finding violations of the securities laws. The Commission itself has acknowledged this prohibition, which was expressly reaffirmed by the Fifth Circuit below. *See* Pet. App. 31-32.[1] As a result, there has been no competent finding in this proceeding that Mr. Steadman breached any fiduciary duty with regard to the transactions at issue.

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[1] The Investment Company Act of 1940 "gives no power to the Commission, an administrative agency, to adjudicate such breaches, and the Commission has held that it cannot do so." Pet. App. 31 (citation omitted). Respondent has not sought review of this limitation of SEC authority.

Moreover, varying the standard of proof depending on the presence of fiduciary obligations makes little practical sense. The Commission itself admitted below that the "boundaries of the fiduciary concept are necessarily hazy. Much often depends on the particular factual setting and the precise questions presented." Pet. Supp. App. 100. There can be no justification for relaxing the standard of proof of violations in disciplinary proceedings based on a "hazy" notion that the Commission has no authority to address.[2]

I. NEITHER THE ADMINISTRATIVE PROCEDURE ACT NOR ANY GRANT OF "AGENCY DISCRETION" PROVIDES SUPPORT FOR THE PREPONDERANCE OF THE EVIDENCE STANDARD IN SEC DISCIPLINARY PROCEEDINGS.

A. Section 7(c) of the Administrative Procedure Act Does Not Address Standards of Proof.

Section 7(c) of the Administrative Procedure Act ("APA"), 5 U.S.C. § 556(d), provides that sanctions may not be imposed "except on consideration of the whole record . . . and in accordance with *the reliable, probative, and substantial* evidence" (emphasis added). Respondent contends that by this language, "Congress meant to endorse the traditional preponderance standard." SEC Br. 42. That contention, plainly

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[2] Respondent's obsessive efforts to characterize Mr. Steadman as a "faithless fiduciary" are similarly inappropriate. It is undisputed that the Funds have benefited substantially from petitioner's allegedly "faithless" conduct and that no one was harmed by petitioner's conduct. Moreover, the SEC rejected findings that petitioner had realized any benefit from the alleged violations. *See* Petr. Br. 14 n.18 and record sources cited there. Finally, respondent's inflammatory version of the facts — which unfairly and inaccurately characterizes Mr. Steadman as a sinister threat to the investing public — is disproved by the SEC's failure, during the ten years that this matter has been pending, to seek injunctive relief to protect the public from his purportedly egregious conduct. *See* pp. 11-12, *infra*.

in error, is refuted conclusively by this Court's prior decisions and by the unambiguous legislative history of the APA.

This Court has held that language virtually identical to that on which respondent relies pertains "not to the burden of proof, but rather to the quality and nature of the evidence upon which [an] order must be based." *Woodby* v. *Immigration and Naturalization Service,* 385 U.S. 276, 283 (1966) (addressing 8 U.S.C. § 1252(b)(4), which required "reasonable, substantial, and probative evidence" to support a deportation order). This Court concluded that by this language, "Congress has not addressed itself to the question of what degree of proof is required." *Id.* at 284.

There is no justification for reaching a contrary conclusion with regard to the virtually identical language of the APA. From the genesis of the phrase "reliable, probative and substantial evidence" in the legislative history,[3] through the legislative debates,[4] and until the post-enactment publication of

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[3] *See* Final Report of the Attorney General's Committee on Administrative Procedure, S. Doc. No. 8, 77th Cong., 1st Sess. 70-71 (1941) ("the ultimate test of *admissibility* must be whether the proffered evidence is *reliable, probative and relevant*") (emphasis added).

[4] "[S]ubsection 7(c) adopts the 'reliable, probative and relevant' standard stated by the Attorney General's Committee (Final Report, p. 71)." S. Doc. No. 248, 79th Cong., 2d Sess. 30 (1946). Substitution of the word "substantial" for "relevant" had no substantive significance. H. Rep. No. 1980, 79th Cong., 2d Sess. 53 n.18 (1946). For other pertinent indications from the legislative history that Section 7(c) addressed the quality of the evidence, *see, e.g.,* S. Rep. No. 752, 79th Cong., 1st Sess. 22, 28 (1945); Administrative Procedure: Hearings Before the Committee on the Judiciary of the House of Representatives, 79th Cong., 1st Sess. 35 (1945) (statement of Carl McFarland); 92 Cong. Rec. (Senate) 2159 (daily ed. March 12, 1946) (statement of Sen. McCarren).

the Attorney General's Manual on the Administrative Procedure Act,[5] the purpose of the language was clear: to regulate the *quality* — not the *quantity* — of the evidence required to support an administrative determination. This conclusion is reinforced by this Court's decision in *Woodby*.[6]

Finally, the APA by its own terms left open the possibility that a standard of proof more demanding than a mere preponderance may be imposed by a court. Thus, Section 12 of the original Act provided: "Nothing in this Act shall be held to diminish the constitutional right of any person or to limit or repeal additional requirements imposed by statute or otherwise recognized by law." *See* 5 U.S.C. § 559 (reflecting subsequent revisions to language but not to substance). Such rights and requirements, for the reasons set forth in our initial brief, warrant a heightened standard of proof. The APA provides no justification or basis for relaxing that standard.

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[5] The Attorney General's Manual, regarded as the most authoritative guide to interpretation of the APA, explicitly recognizes that Section 7(c) was intended to "restate the present law" with regard to the *quality* of the evidence to be considered in reaching administrative decisions. U.S. Dept. of Justice, Attorney General's Manual on the APA 76 (1947). For its source of "present law," the Attorney General's Manual cites Consolidated Edison Co. v. NLRB, 305 U.S. 197, 230 (1938), which required administrative orders to be justified by "evidence having rational probative force. Mere uncorroborated hearsay or rumor does not constitute substantial evidence."

[6] Thus, respondent's reliance on the *dissenting* opinion in *Woodby* is futile. *See* SEC Br. 42. Similarly, respondent's citation of a random phrase in the legislative history cannot undermine the unambiguous conclusion compelled by the evolution of the APA's language and its underlying concerns. *See* SEC Br. 42. There is no indication in the statute or in its legislative history that Congress even addressed the standard of proof, much less purported to resolve the issue for all administrative proceedings, even those authorized by statute after the APA's enactment.

B. Administrative Agencies Do Not Have Discretion To Determine The Standard Of Proof In Disciplinary Proceedings.

Respondent maintains that determining the appropriate standard of proof "is a discretionary decision of the administrative agency." SEC Br. 46. But that contention is undermined by the numerous decisions in which this Court, recognizing "the individual's interest in the outcome," has imposed a requirement of "proof more substantial than a mere preponderance" over the agencies' objections. *E.g., Addington* v. *Texas,* 441 U.S. 418, 427 (1979). *See* Petr. Br. 21 (citing cases). Thus, this Court has not permitted administrative agencies to usurp the function of determining the standard of proof, a function which "has traditionally been left to the judiciary." *Woodby, supra,* 385 U.S. at 284.

There is no justification for allowing such usurpation here. None of the authorities cited by respondent suggests otherwise. *Mathews* v. *Eldridge,* 424 U.S. 319 (1976) (SEC Br. 46), suggests only that with regard to certain procedural rules, weight may be given to the views of administrative agencies — but the decision itself still must be made by the courts. *Mathews, supra,* 424 U.S. at 330. *Vermont Yankee Nuclear Power Corp.* v. *NRDC,* 435 U.S. 519 (1978) (SEC Br. 46), is readily distinguishable for it involved a rulemaking proceeding, not a quasi-criminal adjudicatory proceeding with sanctions as severe as those proposed here. And, of course, neither case cited by respondent addressed the question of standard of proof, which lies peculiarly within the province of the judiciary to resolve. *Woodby, supra,* 385 U.S. at 284.

Further, in light of the compelling bases for inferring congressional preference for a "clear and convincing" standard, there is even less justification here than in ordinary circumstances for deferring to or accepting the agency's preference. *See* Petr. Br. 22-27. As it did in *Addington* and prior cases, this Court should reject the agency's unwarranted attempt to usurp the Court's authority with regard to standard of proof.

II. THE CLEAR AND CONVINCING STANDARD OF PROOF IS REQUIRED TO BALANCE THE COMPETING INTERESTS AND RISKS AFFECTED BY SEC DISCIPLINARY PROCEEDINGS.

In *Addington* v. *Texas,* 441 U.S. 418, 423 (1979), this Court recognized that the standard of proof "serves to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision." Respondent's analysis of the risks and interests affected by SEC disciplinary proceedings is myopic at best. *First,* respondent erroneously assumes that the risks of error in SEC disciplinary proceedings are allocated equally by the preponderance of the evidence standard. That assumption is undermined by the severe imbalance between the SEC and those it seeks to discipline; this imbalance results from the SEC's substantial procedural and institutional advantages that are likely to effect an erroneous decision in the SEC's favor. *Second,* respondent completely ignores the *public* interest in avoiding the unwarranted removal of competent and honest investment advisors. That interest, coupled with the investment advisor's personal interest in avoiding an erroneous adverse decision, surely outweighs the government's interest in SEC disciplinary proceedings. *Third,* the government's interest in SEC disciplinary proceedings is diluted by the availability of alternative regulatory options that protect the investing public without presenting the grave risks and consequences of an adverse disciplinary order.

A. The Clear and Convincing Standard Of Proof Is Necessary Because Of The Substantial Institutional And Procedural Advantages Favoring The SEC.

Respondent's attempt to strike in its favor the balance required by *Addington* rests on a seductive but infirm premise: that the preponderance of the evidence standard allocates equally the risk of error between litigants. That premise may

be true with regard to certain kinds of civil litigation, where the pertinent rules and procedures apply equally to opposing parties. It plainly is not valid with regard to SEC disciplinary proceedings, where the SEC enjoys substantial institutional and procedural advantages over its disciplinary target. Absent a more demanding standard of proof, these advantages ensure that the accused in SEC disciplinary proceedings assumes a much greater risk of an erroneous decision than the government.[7]

The procedural advantages enjoyed by the Commission are both extensive and significant. While the Commission has substantial authority and resources with which to investigate alleged violations in anticipation of a disciplinary hearing (*see,*

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[7] The SEC contends that the clear and convincing standard would "interject serious inaccuracy in the administrative process." SEC Br. 20. That sophistic argument is dismissed by the very authorities on whom the Commission relies.

> "Which, of all various views and procedures, will produce the fewest mistakes in fact finding? *This is a question of fact which only investigation and experiment could really decide.*"

Ball, The Moment of Truth: Probability Theory and Standards of Proof, 14 Vand. L. Rev. 807, 829 (1961) (emphasis added, footnotes omitted). And, as this Court has acknowledged, "there are no directly relevant empirical studies. . . . [T]he ultimate truth as to how the standards of proof affect decisionmaking may well be unknowable . . . ." *Addington, supra,* 441 U.S. at 424-25.

Further, the Commission presumably has disproved its own remarkable contention that the clear and convincing standard of proof "would tend to cause more incorrect decisions than correct ones." SEC Br. 20 n.18. In each of the twenty disciplinary proceedings decided since the D.C. Circuit's decision in *Collins,* the Commission claimed that its findings of fact, supported by clear and convincing evidence, would not have varied if the preponderance standard had been applied. *See* Petr. Br. 9 n.10 (citing cases). While petitioner cannot determine whether those proceedings resulted in "more incorrect decisions than correct ones," it is absolutely clear that *the incremental burden of proof did not increase the number of "incorrect" results.*

e.g., 15 U.S.C. § 78u(a)), respondents in disciplinary proceedings have no rights to engage in pre-hearing discovery. *See, e.g., Charles M. Weber,* 35 S.E.C. 79 (1953), *aff'd,* 222 F.2d 822 (2d Cir. 1955). *See also* 17 C.F.R. § 201.8(d) (1980) (administrative law judges have *discretionary* option to allow respondents *limited* discovery). Respondents have no right to obtain exculpatory material held by the Commission unless it is likely to be introduced at trial,[8] they have no right to conduct discovery depositions or even to learn the identity of prospective Commission witnesses,[9] and they have no pre-hearing access to transcripts of the extensive *ex parte* depositions and interviews conducted by the Commission.[10]

Thus, the Commission has a substantial advantage in developing, discovering and protecting quantities of material that would create a "preponderance" of the evidence. *See generally* Freedman, A Civil Libertarian Looks at Securities Regulations, 35 Ohio St. L.J. 280 (1974). Absent parallel and equivalent opportunities for respondents, there is no assurance that the Commission's "preponderance" accurately reflects the underlying facts. To compensate for this imbalance and to

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[8] The Commission consistently has sustained the staff's refusal to recognize a respondent's entitlement to exculpatory material held by the Commission. *See generally* Mathews, Litigation and Settlement of SEC Administrative Enforcement Proceedings, 29 Cath. L. Rev. 215, 251 (1980).

[9] *See* 17 C.F.R. § 201.15(a) (1980) (allowing depositions by a respondent only if witness is unlikely to be able to attend the hearing); Dlugash v. SEC, 373 F.2d 107, 110 (2d Cir. 1967) (refusing access to witness lists).

[10] *E.g.,* Haight & Co., 44 S.E.C. 481, 510-11, *aff'd,* No. 71-637 (D.C. Cir. 1971), *cert. denied,* 404 U.S. 1058 (1972). *See* 17 C.F.R. § 201.11.1 (1980) (allowing, in limited circumstances, access to pre-hearing statements only *after* the witness has offered direct testimony).

minimize its effect on the accuracy of Commission findings, a more demanding standard is required.[11]

The need for a more demanding standard is even more compelling in light of the questionable quality of evidence admissible in SEC disciplinary proceedings.[12] Because the SEC's "proof" of a violation may include hearsay, conjecture or other incompetent evidence, the *weight* of the evidence in such hearings may be substantially distorted. Administrative law judges "admit all evidence that 'can conceivably throw any light upon the controversy,'" "even though it might be inadmissible before a jury because too remote or conjectural to be properly evaluated by lay triers of fact." *Clinton Engines Corp.*, 41 S.E.C. 408, 411-12 (1963) (footnotes omitted). To ensure an accurate and fair result, a heightened standard of proof is therefore necessary to compensate for the *quality* of the evidence underlying SEC findings of fact.[13] As this Court has

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[11] Contrary to respondent's suggestion, the "extended hearing procedure" in SEC enforcement actions does not "guarantee[] the accuracy . . . of the ultimate result." SEC Br. 25. The objective of the Commission's adjudicatory procedure is "not accuracy," but a balance between "fairness, efficiency and acceptability." 2 K. Davis, Administrative Law Treatise § 10:4 pp. 319, 321 (2d ed. 1979). As a result, "many of the rules . . . are not geared for, but are often aptly suited to defeat, the development of the truth." Frankel, The Search for Truth: An Umpireal View, 123 U. Pa. L. Rev. 1031, 1036 (1975). The rules limiting discovery by SEC respondents, discussed *supra* at pp. 8-9, amply demonstrate this fact.

[12] Although the Commission's decision must be "in accordance with the reliable, probative and substantial evidence," 5 U.S.C. § 556(d), there is no limitation on the admissibility of evidence not meeting those standards.

[13] On certain technical issues, the Commission's expertise may diminish the misleading effect of incompetent evidence. More frequently, however, the Commission possesses no special expertise with regard to crucial factual issues. *See, e.g.*, Klopp v. SEC, 427 F.2d 455, 460 (6th Cir. 1970). This is particularly true with regard to the factual issues in dispute below, such as whether Steadman's alleged statutory violations were willful. *See* Petr. Br. 17-19.

recognized, "[i]ncreasing the burden of proof is one way to impress the factfinder with the importance of the decision and thereby perhaps to reduce" erroneous decisions through more careful scrutiny of the evidence. *Addington*, 441 U.S. at 427.

B. Respondent's Purported Balance Of The Competing Interests Is Inadequate.

Respondent maintains that the appropriate standard of proof should be determined by only two factors: (1) petitioner's interest in avoiding unwarranted imposition of devastating sanctions and (2) the investing public's interest in avoiding dishonest investment advisors. SEC Br. 15-16. On this basis, respondent concludes that the risks of an erroneous decision should be allocated equally between the parties.

But respondent's perception of the competing interests is infirm in at least two respects. First, the analysis fails to address the investing public's interest in avoiding the unwarranted removal or disqualification of a competent and honest investment advisor. That interest, which is at least as weighty as the public's interest in avoiding dishonest investment advisors,[14] is illustrated by the investors who since 1971 have invested in Steadman-managed Funds despite the pendency of these proceedings. Petitioner submits that these competing public interests are approximately equal. Petitioner's personal interest in avoiding an unwarranted adverse decision tips the scale firmly in favor of a more demanding standard of proof. *See generally* Brief of Amicus Securities Industry Association at 10-11.

Second, the "public interest" in protecting investors *through disciplinary sanctions* is far narrower than respondent suggests. The Commission need not rely on disciplinary proceedings to protect investors from the harms caused by unscrupulous investment advisors or unethical investment prac-

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[14] *See, e.g.*, S. Rep. No. 94-75, 94th Cong., 1st Sess. 8 (1975) (emphasizing the public interest in competition among investment advisors and brokers).

tices. For example, the Commission may seek injunctive relief, for which proof by only a preponderance of the evidence may be sufficient.[15] Alternatively, the Commission may publish information concerning violations for the benefit of injured or prospective investors. 15 U.S.C. § 78u(a). The public can thus be protected from harm even if the government is unsuccessful in the disciplinary forum.[16] For the investment advisor who is disciplined improperly, however, there is no alternative forum for *de novo* protection of his interests.[17]

The narrow scope of the government's interest in disciplinary sanctions is particularly apparent in this proceeding. Despite the Commission's harsh characterizations of Mr. Steadman and his conduct, the government has not sought to protect the "public interest" by pursuing against Mr. Steadman injunctive remedies or seeking other relief. *See* p. 3, n. 2, *supra.* The government's failure to pursue alternative available remedies should not be a basis for relaxing the standard of proof in disciplinary proceedings that, unlike the regulatory alternatives, entail grave and irremedial consequences for the individuals involved.

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[15] *See* SEC v. Savoy Industries, Inc., 587 F.2d 1149, 1169 (D.C. Cir. 1978), *cert. denied,* 440 U.S. 913 (1979).

[16] Respondent implies that recognition of a heightened standard of proof in SEC disciplinary proceedings would inhibit government action in other areas. SEC Br. 28. But unlike the imposition of SEC disciplinary sanctions, each government action cited by respondent is the *exclusive* means of protecting the public from a specific harm. Similarly, in Vance v. Terrazas, 100 S. Ct. 540 (1980), expatriation was the only means by which the government could deny the rights of an American national to one who had sworn allegiance to a foreign state. In contrast, the government may protect the investing public by numerous regulatory devices that do not entail punitive sanctions.

[17] The Commission's reliance on SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) is thus misplaced. *See, e.g.,* SEC Br. 30. *Capital Gains* addressed an injunctive action — not a disciplinary proceeding entailing severe sanctions.

In short, the standard of proof should be determined by weighing the following interests: (a) petitioner's interest in avoiding the unwarranted imposition of grievous harm and drastic punishment, (b) the public interest in avoiding the unwarranted removal of honest and competent investment advisors, and (c) the public interest in obtaining *by disciplinary sanctions* protection from dishonest or incompetent investment advisors. We respectfully submit that any reasonable balance of those interests warrants a standard of proof that allocates to the government the greater risk of error.

CONCLUSION

For the foregoing reasons and for the reasons set forth in petitioner's opening brief, the judgment below should be reversed and the cause remanded to the Commission with directions to dismiss all allegations against petitioner.

Respectfully submitted,

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